County of Los Angeles
CHIEF ADMINISTRATIVE OFFICE
713 KENNETH HAHN HALL OF ADMINISTRATION • LOS ANGELES, CALIFORNIA 90012
(213) 974-1101
http://cao.co.la.ca.us

DAVID E. JANSSEN
Chief Administrative Officer

Board of Supervisors
GLORIA MOLINA
First District

YVONNE BRATHWAITE BURKE
Second District

ZEV YAROSLAVSKY
Third District

DON KNABE
Fourth District

MICHAEL D. ANTONOVICH
Fifth District

May 5, 2003

To: Supervisor Yvonne Brathwaite Burke, Chair
Supervisor Gloria Molina
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

From: David E. Janssen
Chief Administrative Officer

RESTRUCTURING OF LOCAL GOVERNMENT FINANCING

On March 18, 2003, your Board asked my office to "provide suggestions… on ways that the system of local government financing can be restructured." This is a complex topic that has been the focus of numerous reports by various commissions and task forces since the passage of Proposition 13 in 1978. While the motion asks broadly about local government financing, this report only focuses on the predicament faced by counties due to their excessive dependence on the State and their limited revenue capacity. In addition, it reviews various proposals that would affect the financing of local government.

The Root of the Problem

Reduced to its simplest form, the problem for counties is that their role and responsibilities bear little relationship to their resources. While it is virtually axiomatic today that governments at every level lack the resources to deliver the services expected of them, this is not a new development for counties resulting from the economic recession or the bursting of the high-tech bubble. The problem is inherently structural and reflects a loss of fiscal independence by counties. Two developments are at the root of the problem.

050503LG_JR

From Local Government to Agent of the State

While the motion asks for suggestions about "local government financing", local governance is only a small part of what counties do today. For example, the County is the local government for only the ten percent of the population living in unincorporated areas. In addition, it performs certain regional functions such as property tax administration, public health, the operation of jails, prosecution of crimes and the provision of public defenders for indigents, throughout the County – all functions mandated by the State. In fact, most of the services provided by counties are not local in nature but are instead Federal and/or State entitlement programs for which counties, in their other role as an administrative arm of State government, receive Federal and State funds. Over half the funds budgeted by counties are monies received for these mandated programs. In addition, counties are generally required to use local funds as match, effectively reducing the amount available for local priorities. As a result, approximately 90 percent of most county budgets are committed to mandated State or Federal programs.

According to a 1999 report by the Public Policy Institute of California, The State-Local Fiscal Relationship In California: A Changing Balance of Power, the transformation of counties from local governments to agents of the State and Federal Government began in the Great Depression, continued through the end of the Second World War and received a further push from the Great Society programs of the 1960's. In 1932, approximately 80 percent of county funds came from own-source revenue. By 1945, that number had dropped to 50 percent. Today it is approximately 35 percent. By contrast, cities receive around 87 percent of their funds from own-source revenue.

With so little own-source revenue, counties have become dependent on State and Federal budgets and have lost control of their own destiny. The problem has become especially acute in recent years because the State, through whom most Federal dollars flow, has been unable to meet its funding commitments to counties. Over the last two years the State has underfunded counties by almost $1 billion by not reimbursing them for increases in the cost of providing services – salary and benefit increases, rents, utilities, etc – and is proposing to do so again in the budget year. In addition, the State is proposing for the second year in a row to not pay counties for over $500 million in State mandated services that they provide, an additional billion dollars of costs that counties will have to absorb.

Proposition 13

The other major development that has contributed to counties' loss of fiscal independence was the passage of Proposition 13 in 1978. Prior to its passage, property taxes were the major source of own-source revenue for counties, providing approximately two-thirds of total revenue. Proposition 13 rolled back property valuations to 1975 levels, capped local property taxes at 1 percent of value and limited annual valuation increases to 2 percent. As a result, property tax revenue statewide was cut in half and counties saw their own-source revenue decline 39 percent in one year. The State responded by implementing a fiscal relief plan – AB 8 – under which it assumed more financial responsibility for health and welfare programs and reallocated property taxes from schools to local governments, backfilling schools with State dollars. Nevertheless, counties saw their most important revenue source reduced and its future growth severely limited.

In addition to limiting property tax growth, Proposition 13 contained two other features that have essentially put counties in a fiscal straight jacket and made them progressively more dependent upon the State. The first was a requirement that special or dedicated local tax increases be approved by two-thirds of the voters. As local governments responded by turning to alternative revenue sources that did not require voter approval, subsequent initiatives – Propositions 62 and 218 – were passed to also require voter approval for general taxes and property-related assessments and fees.

The other feature of Proposition 13 that makes local governments dependent on the State was the assignment of responsibility for the allocation of property taxes to the State. Initially this worked to the benefit of local governments as the State, through the AB 8 bail out, allocated property taxes to offset much of local government's loss from Proposition 13. However, in the 1990's, the State, faced with its own budget crisis, chose to substantially reverse the bail out in order to meet its funding obligation to schools. Counties, because of their heavy dependence on property taxes, were the biggest losers, contributing $2.5 billion or 23 percent of their own-source revenue to the property tax shift. The State initially replaced about 60 percent of the revenue lost by counties after the approval of Proposition 172. However, the new revenue was dedicated to public safety and dependent on a maintenance of effort requirement further limiting county control over their own funds.

While counties have been called upon to play an increasingly larger role in the Federal-State-Local governmental system, they have seen their own-source revenues decline and their opportunity to replace them constrained by initiatives requiring voter approval of most revenue increases. The result has been an increase in their fiscal dependence upon a State government that is itself in fiscal distress.

Alternative Ways to Restructure the System of Local Government Finance

Given that counties today find themselves with responsibilities – most of them imposed by the State – that far exceed their fiscal capacity, there are two basic ways to alleviate the problem. The most radical approach would be to rethink the relative roles and responsibilities of State and local governments, determine which level can best perform each responsibility, and then provide them with the necessary authority and resources to do the job. A more modest approach would leave current roles and responsibilities intact, and focus instead on increasing the fiscal capacity of counties so that they did not have to sacrifice the service needs of their residents in order to finance and deliver Federal and State programs.

A thorough and thoughtful attempt to rethink the roles of State and local government in California was undertaken by the Legislative Analyst's Office (LAO) in the midst of the 1993 State budget crisis. Faced with a Governor's recommendation to reduce the State's cost of funding K-12 education by shifting property taxes from local governments to schools, the LAO concluded that the shift would make a bad situation worse and proposed instead a complete review and restructuring of government at all levels. Their report, "Making Government Make Sense", outlined an "ideal" model of what a restructured State-local system should look like, including the revenue changes needed to make the new system work.

Our April 3, 2003 memo to the Board summarized the LAO's report and recommendations. Consequently this report will examine other ways to improve and strengthen the fiscal capacity of counties including: a State takeover of some county functions of state-wide character or significance; increased State assistance to counties; and improving the ability of counties to raise revenue.

State Takeover of County Functions

While much of the discussion surrounding realignment, both in 1991 and today, has focused on State programs that could be transferred to counties, the realignment process can and has occurred in the opposite direction to provide counties with a measure of fiscal relief. In 1997, the State assumed responsibility for funding trial courts. Although the 20 largest counties must meet a maintenance of effort (MOE) requirement, most counties received immediate relief and even the large counties benefit from the fact that inflation reduces the real cost of the MOE and future increases in court costs are absorbed by the State. In 1999, the State assumed responsibility for child support, providing modest relief to counties since most of the program's funding was Federal and State monies. And in 2002, the State agreed to a phased, negotiated takeover of trial court facilities over a four year period which, while it entails a county MOE, will provide relief over time like the trial court takeover.

While the current realignment discussion does not include any county programs that might be transferred to the State, from time to time various county programs have been suggested for State takeover, including the assessment of certain types of property, the prosecution of crimes, and adult probation. However, given the State's budget problem, it is unlikely to assume any additional responsibilities and costs in order to provide relief to counties for the foreseeable future.

Given State budget realities, a more realistic goal might be to seek mandate relief to remove the obligation to perform certain services, either those deemed to be non-essential and/or those for which the State is withholding reimbursement. In response to the Governor's proposal to defer mandate reimbursement for local governments for a second year, a number of mandate relief bills have been introduced. The following exemplify two typical approaches:

- AB 55 (Ackerman) would require a two-thirds vote of the Legislature to enact a new State-mandate or continue an existing one, and would allow a local agency to cease implementation of any State mandate not reimbursed by the State.

- AB 613 (Campbell) would allow a local agency or school district that has not received full funding for a mandated activity for 2 years to cease to implement that activity, although it could continue the activity with its own funds.

Under the Governor's proposal, while payments to local governments have been deferred, the State is legally obligated to eventually pay local governments with interest. However, under AB 55, if an existing mandate were to fail to receive a two-thirds vote, it would cease to be a mandate requiring State reimbursement. Most mandates entail essential and/or politically popular activities such as the allocation of local property taxes, domestic violence treatment or the provision of absentee ballots. If such mandates failed to be reaffirmed by two-thirds of the Legislature and were thus suspended, local governments could find themselves forced to continue the activities at their own expense without the hope of future reimbursement.

Because AB 613 would make the decision to suspend a mandate a local option, it would not entail the same risks. However, it could result in different problems such as the possible termination of services otherwise required by Federal or State law, the confusion and/or public backlash if certain "mandated" services were available in one county but not in a neighboring county, and whether "optional" mandates are really mandates that the State is obligated to reimburse. Despite the visceral appeal of mandate relief, counties should approach the idea with caution based on past experience with a similar effort in the early 1990's that yielded very little savings for local governments but provided justification for the Governor and the Legislature while they shifted $2.5 billion from counties to schools.

State Assistance to Counties

Given the numerous ways in which State and county finances are intertwined, there are many ways in which the State could assist counties by simply assuming a greater share of funding for joint programs such as In-Home Supportive Services, Foster Care Grants or Child Welfare Services. Unfortunately, the Governor's realignment proposal reflects the realities of the budget situation by eliminating the State share for these and other programs and shifting 100 percent of the non-Federal share to counties.

In recent years, proposals to provide direct assistance to local governments have focused on returning the property taxes shifted from counties and cities to schools during the State budget crisis in the early 1990's. In FY 2002-03 the total value of the taxes shifted to Educational Relief Augmentation Funds (ERAF) totaled $4.7 billion, of which $3.6 billion came from counties. Los Angeles County's contribution amounts to $1.2 billion, approximately 30 percent of the total for counties. While counties receive an estimated $2.2 billion (including $502 million for Los Angeles County) in "replacement" funding from the Proposition 172 sales tax, the gap between property taxes lost and sales taxes gained is wide and growing. Even if one includes another $200 million to $300 million in other "replacement" relief provided by the State – trial court funding, the COPS program, general assistance relief, and fines and forfeitures, the net loss to counties is over $1 billion.

Despite local government demands to eliminate ERAF and return property taxes to local governments, legislative proposals have tended to be more limited. In 1999, faced with resistance from the Administration to any form of permanent relief, the Legislature provided $150 million in one-time relief (AB 1661). In 2000 the Legislature overwhelmingly passed SB 1637 (Burton) which capped the amount of property taxes transferred to ERAF so that local governments could share in the future growth of ERAF property taxes. However, the bill was vetoed by Governor Davis.

In subsequent years, legislative proposals have taken a different tack. In an effort to address the Governor's concern about the State's ability to afford even a partial reversal of ERAF, various bills have been introduced to provide for a phased elimination of the shift contingent on the condition of the State General Fund. While the bills have moved easily through committees and even one house of the legislature, usually without opposing votes (for example, AB 2100 in 2002), they have yet to pass both houses and make it to the Governor's desk. While similar proposals have again been introduced in the current session, there is no reason to think the outcome will be any different.

Improving the Ability of Counties to Raise Revenue

The fiscal weakness of counties stems in large part from the fact that, unlike cities, they lack the authority to levy a tax unless specifically authorized by the Legislature. In addition, when counties succeed in obtaining taxing authority, it usually applies to only the unincorporated areas of a county, which in Los Angeles County severely limits the amount of revenue that can be raised. Finally, as a result of a series of initiatives approved by the voters starting with Proposition 13 in 1978, the ability of counties to raise revenues authorized by the Legislature has been made extremely difficult.

Under existing law, counties have the authority, subject to approval by two-thirds of the Board of Supervisors, as well as the voters, to levy a local sales tax of up to1½ percent. Los Angeles County, which has imposed two ½ percent countywide sales taxes for transit operations, would seem to have the capacity to levy another ½ percent. However, because the City of Avalon has imposed a ½ percent tax for a local hospital district, the County is considered to be at the maximum rate.

Because of these constraints, alternatives that could provide counties with significant additional revenue tend to be both limited and politically tenuous. Some of the proposals currently under consideration in the Legislature that would either yield more revenue or make it easier for the County to raise more revenue include:

- SB 726 (Romero), a County sponsored measure to allow a county board to levy a tippler's tax of 5 percent on alcoholic beverages consumed on-site, subject to approval by a majority of voters. Estimated revenue for the County could be as much as $250 million annually.

- SB 566 (Scott) which would raise the local sales tax limit for Los Angeles County to 2 percent and provide an alternative method of increasing the local sales tax through a voter initiative, without Board of Supervisors approval, subject to the relevant voter approval requirements. An additional ½ percent sales tax would yield approximately $500 million annually.

- AB 1690 (Leno) which would authorize a city or county to form a public safety finance agency to provide additional funding for fire protection, police or sheriff services, and further authorize a local government that does so to levy a local income tax, subject to approval by a majority of voters. In addition, the sponsoring local government would be required to transfer property tax revenue equal to 50 percent of the estimated local income tax collection to the agency. The county income tax would essentially be a surtax of up to 2 percent of an individual's state tax liability. Based on returns for 2000, a 2 percent surtax in Los Angeles County would raise approximately $165 million.

- SB 17 (Escutia) which declares legislative intent to take action to tighten the circumstances under which commercial and industrial property can change ownership without triggering a reassessment to market value.

- ACA 9 (Levine) which reverses the voter approval requirements so that special taxes would only need majority voter approval and general taxes would require a two-thirds vote.

- ACA 10 (Harman) which would exclude fees for storm and urban water runoff from Proposition 218's requirement for voter approval.

- ACA 15 (Wiggins) which would allow a local government to impose a special tax to support firefighting, police, medical, sheriff, or other emergency services with approval by a majority of the voters.

- SCA 11 (Alarcon) which would reduce the voter approval requirement for local special taxes for infrastructure and for local infrastructure bonds from two-thirds to a majority. ACA 14 (Steinberg) is a similar proposal.

- A potential constitutional amendment to require the assessment of all commercial and industrial property once every five years. If approved, it could yield approximately $470 million in new property taxes in the County, of which some $120 million would be the County's share.

With the exception of SB 726, which is County sponsored, the Board has not taken a position on any of these proposals. However, AB 1690 is co-sponsored by the Sheriff.

The Redistribution of Property Taxes

Proposition 13 radically altered the balance of power between the State and local governments in California, especially for counties. In addition to drastically reducing the principal source of county-own source revenue, it placed the State in charge of allocating property taxes after valuations were rolled back to 1975 levels. The State's response was to consolidate property taxes at the county level and allocate them to local jurisdictions based upon the fiscal reality of the time – each jurisdiction's share of property taxes in 1975-76 – on the assumption that this represented the willingness of jurisdictions and voters to tax themselves for the services they provided. When the State backfilled local governments in 1979 with property taxes from schools, the backfill was also based upon this allocation, as was the partial reversal of the backfill in the early 1990's.

Consequently, the allocation of property taxes has not changed significantly in the 25 years since Proposition 13. Local jurisdictions with a relatively high property tax burden in 1975-76 continue to receive a relatively high allocation of property taxes while jurisdictions with a relatively low property tax burden then receive a lesser allocation. Among large urban counties, (not including San Francisco which is a combined city-county with an exceptionally high allocation), the variation ranges from approximately 25 percent for Los Angeles to 6 percent for Orange.

Some jurisdictions with low allocations claim that their allocation is unfair and urge reform of the State-local fiscal relationship to achieve a more equitable distribution of property taxes. However, the fact that one county has a greater allocation of property taxes than another's does not necessarily mean the distribution is unfair or inequitable. And solving the alleged problem by giving all counties the same percentage allocation may or may not be more equitable. Any judgment about the current distribution of property taxes or proposals to change it needs to be based upon some agreed upon equity standard.

One such standard is contained in the LAO's 1993 report "Making Government Make Sense", which proposed a swap of 1 percent of local sales tax for an equal amount of property taxes, similar to what is being advocated today. However, instead of a dollar for dollar swap, the LAO proposed a reallocation of property taxes. The LAO's proposed reallocation was in two-steps in recognition of the dual role of local governments as providers of municipal services and as agents of the State and Federal governments. The first allocation was calculated on an equalized basis (similar to school funding), taking into account each jurisdiction's total resources, in order to assure that every community could afford a base level of traditional municipal services. The second allocation for the other services provided by local governments such as mental health, foster care, and child welfare services was based on some measure of need or demand for those services such as caseload. While the two allocations are arrived at differently, both are based upon a needs-based determination of what is equitable or fair given that local governments share the same basic functions but have widely disparate fiscal resources to pay for them.

Currently, Orange County Supervisor Chris Norby is proposing an even larger swap of local taxes in return for property taxes. A copy of the proposal and supporting material is attached. Under the Norby proposal, which is entitled FRESH (Fiscal Reform: Equity, Stability, Harmony), local governments would give up their 1 percent local sales tax and their entire VLF to the State, which would use the revenue to reimburse schools for the entire amount of property taxes they currently receive which would be shifted to local governments. However, as with the LAO proposal, local governments would not be reimbursed dollar for dollar for their lost revenue. Instead, the entire amount of school property taxes would be reallocated to local governments on a new basis that would replace the AB 8 distribution.

Under the FRESH proposal counties would receive 40 percent of the property taxes collected within their cities and 100 percent of the property taxes in their unincorporated areas. Cities would receive the remaining 60 percent of the property taxes within their jurisdiction. Redevelopment agencies would be merged into cities, giving cities the option of using redevelopment funds not committed to debt service for general government purposes. And special districts currently receiving property taxes would lose those taxes on the assumption that they would be made whole through a transfer of general fund monies from their respective cities and counties. Enterprise special districts such as water, refuse, etc, would become self-sufficient, relying totally on their ratepayers with no general fund subsidy.

Because the FRESH proposal is only conceptual and still evolving, it is difficult to analyze how it would work or to estimate its precise impacts. Some estimates of specific impacts are provided in the FRESH material. Others used in the analysis were prepared by my staff. All are based on the most recent State Controller's reports which are four and five years old. While the actual dollar figures have changed in the interval, the percentage figures used in the analysis are nevertheless indicative of the direction and magnitude of the proposal's impacts today.

Though it is not stated in the FRESH material, it appears that the amount of property taxes that would be transferred to local governments – approximately $13.6 billion – is $2 billion to $3 billion greater than the sales and VLF revenue transferred to the State. As a result, the proposal entails a potential State cost of up to $3 billion to backfill schools. Otherwise the gain to local governments would be at the expense of schools. Given projections of State budget shortfalls for the next few years, such a large increase in funding to local governments is unlikely, whatever the merit of the proposal.

Supervisor Norby has stated that every county and 90 percent of the cities would gain revenue under his proposal. In the few examples of counties provided, Los Angeles County would experience a revenue gain of about 7 percent, while Orange County would see a 150 percent increase, San Bernardino 85 percent, and San Diego 76 percent.

However, even if all counties actually receive more money, it apparently would not be discretionary money or amount to a real gain. The most recent version of the FRESH proposal, under the section "School Funding", states that "counties (would) assume operation of certain state functions commensurate with the extra funding they receive." In other words, the proposal seems to have a "realignment" component that imposes new responsibilities on counties (but apparently not cities) that would be financed by their new revenue. (It would also reduce, but not eliminate, the State's shortfall from the revenue transfer.)

No detail is provided as to what State programs or activities would be transferred or why, only cities would enjoy a windfall; however, the proposed realignment is problematic. In the absence of information about which programs would be transferred to counties and the cost of those programs within each county, it is impossible to estimate actual impacts. Nevertheless, if every county must assume additional program and funding responsibilities equal to their gain in revenue, there is effectively no gain to any county. Moreover, since the allocation of county property taxes is based on the 40 percent/100 percent formula, it is not possible to assure that a county's new revenues will match its new responsibilities which are caseload driven, unless every counties sharing ratio is assumed to be different.

The FRESH proposal poses an additional problem, especially for counties, in its treatment of special districts which would lose their property taxes on the assumption that they would be backfilled by their respective cities and counties. In the case of county special districts which serve residents of cities as well as unincorporated areas (flood control, fire and library districts, for example) for every dollar of property taxes surrendered by a special district that was collected in cities, a county would only receive 40 percent or 40 cents from the taxes collected in those cities. However, counties would be responsible for making the special district whole by transferring some of its general fund dollars. Either the special district or the county general fund would be seriously shorted. It does not appear that in Supervisor Norby's proposal that every county will gain additional revenue has been taken

\ into account.

As for cities, since they would not have to assume additional responsibilities, it seems reasonable that the vast majority would benefit from the windfall. No examples are provided of cities that do not, though there are likely to be those that rely heavily on sales tax revenue rather than property taxes such as Cerritos. As for cities that do benefit, according to FRESH examples, Los Angeles would gain 25 percent, Long Beach 28 percent, and Santa Monica 77 percent. Beyond Los Angeles County, Anaheim would experience a gain of 49 percent, Irvine, 41 percent, San Jose, 80 percent and San Diego, 18 percent.

While most cities seem to win under the FRESH proposal, some clearly win more than others. Some of the wealthiest communities in Los Angeles County do very well. For example, Beverly Hills' increase would be almost 100 percent, Malibu's almost 400 percent, Rancho Palos Verdes 450 percent, and Hidden Hills and Bradbury's over 700 percent. In Orange County, both Laguna Beach and Newport Beach would see increases over 100 percent. In the case of Hidden Hills and Rancho Palos Verdes, their resulting revenue would far exceed their total budget. By contrast, Cudahy would experience a 5 percent increase, La Puente 31 percent, Covina, 34 percent and Hawaiian Gardens 40 percent.

On its face the FRESH proposal seems to treat all cities and counties alike by using uniform allocation formulas. However, the resulting allocations are anything but uniform and are arguably unfair. The principal factor that determines who wins and to what extent under the FRESH proposal is a jurisdiction's per capita property tax base. The larger the property tax base, the larger the amount of the allocation. While property poor cities also gain because of the infusion of additional money, the relative disparity between property poor and property rich cities only widens. In short, in reversing the perceived inequities of the AB 8 allocation, the FRESH proposal replaces it with the oldest inequity of all in local government finance – property wealth.

As noted earlier, counties would at best come out even and possibly lose under the FRESH proposal. Most cities, on the other hand, would do well. Given that counties, and not cities, were the major losers under the property tax shift, this result seems contradictory. Assuming the State somehow could afford to add $2 billion to $3 billion to the local government finance system, there are fairer and more efficient ways to reform it, including along the lines of the LAO's 1993 proposal which considered both fiscal capacity and need for services in allocating local resources. In the absence of real reform based upon such factors, counties would be better off continuing to seek a partial or phased return of the property tax shift.

In addition to the less than desirable impacts of the proposed reallocation of taxes, local governments, especially counties, should be cautious about becoming too dependent on a single source of revenue such as the property tax. Since every tax tends to perform differently in any given economic condition, it is generally considered advisable to have a diversified portfolio of revenue sources to assure stability or modest growth.

While property tax revenues have experienced good growth recently due to a booming real estate market, this has not always been the case as we saw during the recession of the early 1990's. Some economists maintain that there is a "bubble" in real estate values in California today that will burst when interest rates inevitably rise. If true, property tax revenues could decline as they did in the early 1990s. The local sales tax that would be transferred is not a major revenue source for the County, accounting for around $43 million annually. However, the VLF is a major County revenue source that has grown by over 8 percent annually in recent years and has helped to balance slow or no growth in other revenue sources.

The FRESH proposal is clearly unrealistic given the State budget crisis. Moreover, it will likely encounter enormous resistance once its impacts and implications are better understood. If equity is to be pursued in the current legislative session, a more realistic proposal is needed. Some, including Norby, have looked with favor upon AB 1221 (Steinberg-Campbell).

AB 1221 would reduce the local sales tax in cities and counties by ½ of 1 percent and replace the revenues lost by shifting property taxes from schools which would be backfilled by a ½ of 1 percent increase in the State sales tax. Since AB 1221 would replace local sales taxes dollar for dollar with property taxes, it does not involve the redistribution of property taxes like the FRESH proposal or even AB 680 (Steinberg) which failed to pass last year. Instead, AB 1221 focuses on the "fiscalization of land use" whereby local governments determine land use decisions based on the costs and benefits of a particular type of development (industrial, commercial, or residential).

Local governments have probably always engaged in such calculations (if they are fortunate to have the choice, since not all cities are attractive sites for large retail developments). However, because of the limited revenues generated by a retail development under the Proposition 13 property tax system, other factors have tended to diminish the importance of property taxes in this calculation. Property tax revenue is weighed against the cost of services required by a particular type of development, making certain types of "low impact" developments such as retail and office parks preferable to high service demand developments such as housing. When you add to the equation the fact that cities on average receive only 10 percent of the property taxes as compared to 100 percent of the sales tax revenue generated within their borders, the lure of large retail development is almost irresistible.

AB 1221 seeks to make retail developments less irresistible by cutting the local share of general purpose sales taxes in half in the hope of encouraging local governments to develop more housing. Given California's shortage of housing, especially affordable housing, this is a desirable policy goal.

AB 1221 would only minimally impact Los Angeles County because the County's general fund sales tax revenue is only $43 million. Consequently, the bill would transfer only $21.5 million of County sales tax revenue. AB 1221 is really aimed at cities and their competition for development to maximize sales tax dollars. However, despite its excellent intentions, it is doubtful that simply reducing a city's sales tax yield on new retail development will end the competition given the underlying economic realities. Even with their sales tax yield cut in half and their average property tax yield increased to roughly 20 percent, cities will still have a strong incentive to choose a large retail development over a comparably sized housing development because housing does not generate any supplemental revenue and the cost of its service needs exceed those of a retail development. Moreover, to the extent the bill's goal is to encourage affordable housing, which generates even less property tax revenue than the average new home, simply swapping property taxes for sales tax revenue is not likely to have much impact on the supply. While AB 1221 is a clearly a step in the right direction and will on the margin make non-retail development more attractive, it does not do enough to level the playing field between retail and housing development, especially affordable housing development. The bill has been approved by the Assembly Local Government Committee and Revenue and Taxation Committee and is currently in the Appropriations Committee. It is supported in principle by the California Association of Counties and opposed by the California League of Cities.

Fundamental reform of the State-local fiscal system is unlikely without sufficient funding to hold losers harmless so that they will not block reform. Assuming there is agreement on the problem or "inequity" in need of corrective action, a more realistic approach that did not require new State dollars would seem advisable. For example, if the "inequity" in need of correction is a low allocation of property taxes, a constitutional amendment could be pursued to allow a local jurisdiction to exceed the 1 percent limit if they can convince a majority of their voters of the need. If the "inequity" in need of correction is that there is a wide disparity in the fiscal capacity of local jurisdictions to provide basic services, the disparity could be reduced through a regional tax sharing plan that utilized some portion of future regional tax base growth to bring below average jurisdictions closer to the regional average over time. Or if the "inequity" in need of correction is the fact that a given city enjoys the sales tax benefits of a large retail development while its neighboring communities provide customers and absorb costs for traffic, policing, trash, pollution, etc., these external costs could be addressed by sharing some portion of the retail development's sales tax growth with affected jurisdictions on a per capita basis. While all of these approaches are feasible in the sense that they are used in other states, none are currently being considered in the Legislature.

Despite an apparent consensus that the State-local fiscal relationship in California is dysfunctional and ought to be fixed, there is no agreement on how to fix it. In the absence of substantial State dollars to ease the transition to a new local government finance system, fundamental change is unlikely. We will continue to track and report on specific proposals as they surface. If you have any questions or require additional information, I can reached at 974-1101, or your staff can call John Redmond at 974 -1348.

DEJ:GK
MAL/JR:zo

Attachment

c: Executive Officer, Board of Supervisors
County Counsel
Auditor-Controller